No. 12664

In the United States Court of Appeals for the Ninth Circuit

Commissioner of Internal Revenue, petitioner

v.

Grace H. Kelham, Leila H. Neill, Ellis M. Moore, Harriet H. Belcher, and Lillie S. Wegeforth, respondents

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

REPLY BRIEF FOR THE PETITIONER

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INDEX

Cases:

Statutes:

Miscellaneous:

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The taxpayers' contention, in their own language, is that (Br. 19-20) "an operating deficit as of March 1, 1913 must be restored by subsequent earnings before there are any accumulated earnings or profits available for dividends." Again, it is stated (Resp. Br. 7) "It is a contradiction in terms to say that a corporation has accumulated profits when its capital is impaired." This contention and this observation, which express the ultimate import of the taxpayers' argument, would possess validity if the statute under consideration simply made the corporation's accumulated earnings or profits the frame of reference for ascertaining what corporate distributions should be taxable as divi-

dends to the stockholders. Code Section 115 (a)(1), however, is concerned with earnings or profits *"accumulated after February 28, 1913,"* (italics added) a date which the taxpayers conveniently overlook or minimize. There is, however, no contradiction in concluding that a corporation can accumulate profits after a specified date despite the existence of a prior deficit—so long as the deficit was incurred before the date specified in the statute as the starting point for making the measurement. It is the taxpayers' argument which seeks to contradict the statute, for they contend that no matter what Section 115 (a) says about profits accumulated after February 28, 1913, it really means that such profits are to be measured by what was accumulated during the entire corporate history, if the corporation possessed a deficit on March 1, 1913.

To the extent that the taxpayers' brief simply echoes the rationale employed by the Tax Court, no reply seems necessary. We believe that the Commissioner's opening brief has sufficiently demonstrated that none of the reasons advanced below justify the manner in which the Congressional purpose has been obfuscated and the statutory language ignored. To the extent that the taxpayers now renew additional arguments in an attempt to bolster the decision below, we shall demonstrate them to be without merit, a conclusion which even the Tax Court seems to have shared since it did not see fit to adopt those arguments in its opinion.

A. The Constitutional Argument

The taxpayers assert that it would be unconstitutional for Congress to tax as income to the shareholders any distribution out of corporate earnings accumulated after February 28, 1913, without first applying such earnings to eradicating a corporate deficit existing on

March 1, 1913. (Br. 28-30.) The constitutional objection is founded on the assumption that such a distribution would be (Br. 29) "a return of capital" and not income "within the terms of the Sixteenth Amendment to the Constitution * * *." The notion that such a distribution involves a return of capital is also repeated by the taxpayers elsewhere. (Br. 15, 31.)

A contention that a statute would be unconstitutional if construed in harmony with the legislative intent ought not to be lightly advanced. It is surprising, therefore, that, having raised such a serious matter, the taxpayers should not bother to elucidate how such distributions would constitute a return of capital or cite any authority to prove their assertion. Any consideration of the matter, however, will make it apparent that there is not the slightest foundation to support the taxpayers in this matter.

Initially, it should be observed, as we pointed out in our opening brief (p. 20), that Congress, ever since 1936, has taxed the shareholders on all distributions out of the corporation's current earnings and profits, even though the corporation may possess an accumulated deficit in its earnings and profits at the time when the distribution is made;[1] no one has ever challenged the validity of this. Indeed, while this very matter was involved in the computations required by these cases, the taxpayers here do not question the power of Congress to tax such distributions as income. (Resp. Br. 30.)

If a distribution of current earnings to the stockholders does not constitute a return of capital, notwithstanding that the corporation's capital is then

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[1] It should be noted that, while this provision originated in Section 115 (a), clause (2) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, when the tax on undistributed profits came in, it remained even after that tax failed to be renewed, and it exists today in Code Section 115 (a).

impaired, we fail to comprehend how a corporate distribution involves a return of capital if there is a pre-1913 deficit which has not been restored. We note that counsel for the taxpayers (Br. 29-30) state that they considered this matter and concluded that such a distinction does exist. However, we can discover no valid basis for their conclusion and they have demonstrated none. If the statute is unconstitutional in the respect claimed by the taxpayers it must also be considered invalid in taxing distributions out of current earnings when there is an existing deficit.

The absurdity of this constitutional objection, however, seems plain. If a stockholders "equity" in the corporation's surplus as of March 1, 1913, does not represent capital to him, so that a subsequent distribution of that surplus may be constitutionally taxed, as was held in *Lynch* v. *Hornby,* 247 U.S. 339, it is an *a fortiori* conclusion that, where the corporation has a deficit on that date and later makes distribution out of subsequent earnings, no capital is being returned to the shareholder. So long as the stockholder's stock interest in the corporation is retained by him, any distribution of the corporation's earnings is a return *on* his capital, not a return *of* his capital, and the gains thereby derived can be constitutionally taxed as income to him. It makes no difference when those earnings inured to the corporation, or what effect their declaration as a dividend has on the corporation making the distribution. *Lynch* v. *Hornby*, 247 U.S. 339, 344, 346. The income, in its constitutional sense, received by a stockholder who receives a dividend out of corporate earnings is not affected by whether the corporation does or does not possess a deficit at that time. Since the stockholder's interest as a stockholder remains intact, his capital remains intact, and such a distribution does not at all involve a return of capital to him. Cf. *United*

States v. *Phellis,* 257 U.S. 156, 171-172; *Taft* v. *Bowers,* 278 U.S. 470, 483-484; *Koshland* v. *Helvering,* 298 U.S. 441; *United States* v. *Safety Car Heating Co.,* 297 U.S. 88.

What the taxpayers are really contending for is a constitutional rule requiring Congress to restore to them the "equity" which they would have possessed on March 1, 1913, if the corporation had not suffered losses and an impairment of its capital before that time. No such guarantee was imposed by the Sixteenth Amendment. See *Lynch* v. *Hornby, supra.* Cf. *Helvering* v. *Canfield,* 291 U.S. 163.

Since Congress could constitutionally tax such distributions, it seems plain that the Tax Court could not be right in its conclusion unless Congress has refrained, in this particular respect, from exercising its constitutional power to the fullest. The pertinent question that must be answered is why Congress should have considered that such income ought not to be taxed. Neither the Tax Court nor the taxpayers have suggested a single, valid reason which would have motivated the legislature to do so.[2] On the contrary, as we have shown, the only legislative purpose has consistently been to tax, when distributed, all corporate profits accumulated after March 1, 1913, as well as distributions out of current earnings. (Pet. Br. 16-20.)

B. The Argument Based on Other Statutory Provisions

In the attempt to prove that Section 115(a)(1) does not mean what it says in referring to earnings or profits

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[2] The only explanation offered by the taxpayers is on the theory that Congress did not create an exemption but that, because of constitutional limitations (Br. 30-31), "Congress did not intend to levy a tax on a return of capital." Since the assumption that this is a return of capital is fallacious, we are left with no explanation at all respecting why Congress should have exempted such income when it could have constitutionally subjected it to tax.

"accumulated after February 28, 1913," the taxpayers make an involved argument (Br. 19-28) based on the language of Section 201 (d) of the Revenue Act of 1924, c. 234, 43 Stat. 253, and corresponding provisions of intervening Acts, prior to those of the Revenue Act of 1936. While the exact purport of what is supposed to be established by this argument is far from clear, we shall show that nothing of aid to the taxpayers has been or can be proved by the provisions referred to.

Prior to the Revenue Act of 1921, there was no statutory provision dealing with the effect on the basis of stock to a shareholder who received corporate distributions which were not taxable as dividends or which were not otherwise exempt from tax. Such a provision was enacted in Section 201 (c) of the Revenue Act of 1921, c. 136, 42 Stat. 227, which in effect, provided that such distributions to the shareholders would reduce the basis of the stock for the purpose of determining gain or loss on a subsequent disposition of the stock. It did this, it should be noted, by language geared to Section 201 (a) and (b) which contained the definition of a taxable dividend. That is, Section 201 (c) referred to distributions which were not out of earnings accumulated, or increased in value accrued, prior to March 1, 1913; it provided that all other distributions (since these would not constitute taxable dividends under Section 201 (a) and would not be exempt from tax under Section 201 (b)) should be applied against the basis of the stockholder's stock.[3]

It should be emphasized that, because Section 201 (c) repeated the exact language of Section 201 (a) and (b), there can be no doubt that the legislature was pro-

[3] Section 201 (b) made a separate provision providing that distributions out of pre-1913 earnings should reduce the basis of the stock for purposes of loss. Being silent on the matter, the statute did not require such a reduction of basis for purposes of determining subsequent gain.

viding that a distribution should reduce basis only if it was not a taxable dividend under Section 201 (a) or was not exempt from tax under Section 201 (b). The repetition of the language of Section 201 (a) and (b), to the extent that it casts light on the Congressional intent regarding the present problem, actually strengthens our argument that Congress was not repeating unnecessary language when it separately referred to earnings or profits "accumulated since February 28, 1913" and that it did not intend that the crucial date should be read out of the statute. (See Pet. Br. 12-15.)

Section 201 (a) and (b) of the 1924 Act contained the same essential definition of a dividend as was embodied in the 1921 Act. Section 201 (b) made one major change over existing law by providing that distributions out of pre-1913 earnings should reduce the basis of the stock for both gain and loss. H. Rep. No. 179, 68th Cong., 1st Sess., p. 11 (1939-1 Cum. Bull. (Part 2) 241, 249); S. Rep. No. 398, 68th Cong., 1st Sess., p. 11 (1939-1 Cum. Bull. (Part 2) 266, 274). (See fn. 3, *supra.*)[4] Section 201(d) of that Act corresponded to Section 201 (c) of the 1921 Act. The only change of substance was the addition of a sentence to the effect that its provisions should apply so that distributions from depletion reserves based on discovery value should also reduce the basis of stock. That section also stated explicitly that, to the extent that such distributions exceeded basis, the distributees should be taxed with gain. This was only inherent in the 1921 Act, but its provisions had been so applied and the language of the 1924 Act was considered declarative of existing law. (H. Rep. No. 179, *supra,* p. 12; S. Rep. No. 398, *supra,* p. 12.)

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[4] Such distributions, to the extent that they exceeded basis, however, were not taxable as gain until Section 115 of the Revenue Act of 1936.

The language of Section 201 (d) of the 1924 Act, however, differed in other respects from the 1921 Act. Unlike the 1921 Act, which referred to distributions which were not out of earnings or profits accumulated since February 28, 1913, or out of those accumulated prior to March 1, 1913, Section 201 (d) of the 1924 Act simply referred to distributions which were not out of "earnings or profits." The taxpayers' argument is premised on the assumption that (Br. 24) "Congress deliberately changed the language" and that it meant "earnings or profits whenever acquired, either before or after March 1, 1913." The conclusion which the taxpayers would apparently have this Court derive is that, because of this change in Section 201 (d), the statutory definition of a dividend (even though that Act (Section 201 (a) and (b)) as was true of all prior and succeeding Acts, and the Internal Revenue Code, constantly defined a dividend in relation to earnings or profits accumulated after February 28, 1913) did not mean that the accumulations were to start their measurement on March 1, 1913. The argument, however, is one where both the major and minor premises are erroneous, so that the conclusion is inescapably fallacious.

The basic assumption that the change in language in Section 201 (d) of the 1924 Act represented a deliberate intention by Congress to change the meaning of the previous statutory provisions in this respect, is directly contradicted by the legislative history. Thus, the House Committee Report (H. Rep. No. 179, *supra,* p. 12) which otherwise specifically described all changes in substance that were being made over the 1921 Act, did not even intimate that any changes were contemplated in this respect by Section 201 (d). It merely stated that that section (p. 12) "corresponds to subdivision (c) of section 201 of the existing law." It proceeded to paraphrase the new language, but said noth-

ing to indicate that a substantive change was intended. The same is true of the Senate Finance Committee Report which, significantly, did describe a change of substance recommended by that committee and which was subsequently enacted into law, namely the extension of the section to apply to distributions from depletion reserves based on discovery value. (S. Rep. No. 398, *supra,* p. 12.) In view of the failure of the committees to indicate otherwise, the only permissible conclusion is that the 1924 Act did not intend to make any change in substance respecting the meaning of a dividend, and that Section 201 (d) was still geared to Section 201 (a) and (b).

Furthermore, if Congress had intended to change the definition of a dividend, it seems safe to suppose that the legislature would have altered the language of definition contained in Section 201 (a), and would not, in describing what are dividends, have employed a devious approach hidden in the provisions relating to distributions which were not dividends. The fact that Section 201 (a) and (b) was not altered in this respect, and has never yet been so changed, is conclusive that no such alteration in meaning has ever occurred.

The taxpayers might be suggesting that Congress, in 1924, intended to achieve the same result that the Tax Court reached in this case, and, realizing that the existing statutory language of Section 201 (a), in referring to what was accumulated since February 28, 1913, was not acccurate, attempted to correct the statutory language to accord with the legislative intent. If this is what the taxpayers are urging, the same answer suffices—if Congress had so intended, it would have revised the definition of a dividend in Section 201 (a)—not the provisions relating to capital distributions in Section 201 (d).

The ultimate conclusion is plain—the 1924 Act in no respect changed the nature of what distributions should be taxed as dividends and what distributions should be considered as returns of capital. The purpose to tax as dividends all distributions out of earnings accumulated after March 1, 1913, remained the same as it was before and as it has been ever since. The taxpayers merely assume the conclusion yet to be proved, and do so erroneously, when they assert (Br. 25) that in 1935 Oceanic could have distributed its earnings which were accumulated after February 28, 1913, and that such a distribution would have been considered a return of capital to the stockholders. There never has been a time when such a distribution would not have been taxed as a dividend to the distributees.

C. The Claim of Inconsistency

The taxpayers go far afield in a futile attempt to establish that the present position of the Commissioner has not always been the view of the Bureau of Internal Revenue. The reference (Resp. Br. 10-11) to the excess profits tax provisions of the Revenue Acts of 1918 and 1921, and to Article 838 of Treasury Regulations 45 and 62, promulgated thereunder, which required an examination of profits and losses "from the original organization of the corporation down to the taxable year," is entirely misplaced. Thus, Section 326 (a) (3) of the Revenue Act of 1918, c. 18, 40 Stat. 1057, included in invested capital "paid-in or earned surplus and undivided profits." Since Congress was interested in what investment of the stockholders remained in the business, the statute made no distinction between profits accumulated before or after March 1, 1913, and the Commissioner's Regulations properly referred to the entire corporate history.[5]

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[5] *Troy Record Co.* v. *Commissioner*, 11 B.T.A. 298, on which the taxpayers rely (Br. 11-12), establishes nothing. The issue there

Thus, there is an important distinction between what is included in invested capital and what is the source of dividends, the latter but not the former making accumulations after February 28, 1913, an important line of demarcation. The taxpayers' difficulty is that here, as elsewhere, there is a subtle attempt to overlook the statutory language which defines a dividend and which does make it important to determine what has been accumulated since February 28, 1913. For the same reason, the reference (Resp. Br. 12-13) to G.C.M. 1552, VI-1 Cum. Bull. 10 (1927), which involved a post-1913 deficit, has no relevance to the situation here. (See Pet. Br. 24-25.)

D. The Canfield Decision

In contending (Br. 13-15) that the Commissioner's position in this case was repudiated in *Helvering* v. *Canfield,* 291 U. S. 163, the taxpayers misconceive not only the Commissioner's contentions here but also what was decided by the Supreme Court in that case. The taxpayers state that the Commissioner is contending that (Br. 13) "to determine earnings or profits accumulated since March 1, 1913, it is merely necessary to strike a balance of gains and losses since that date" and that the *Canfield* case (Br. 14) "conclusively establishes that the concept of the government in the instant case * * * is fallacious."

The Commissioner's position has been misinterpreted by the taxpayers and there is nothing in our opening brief which could possibly warrant this. The

involved the amount of invested capital and there was no issue respecting the taxability of the dividends. The decision, moreover does not disclose sufficient facts to permit any conclusion whether, if that had been the issue, the dividends would have been taxable, i.e., whether there were sufficient earnings accumulated after March 1, 1913. The inference that the Commissioner took a position in that case inconsistent with the contentions made here is not warranted.

Commissioner's contention has been plainly stated, namely, that Section 115 (a) of the Code requires an ascertainment of what earnings or profits have been accumulated after February 28, 1913, and that Congress plainly intended to tax as dividends all distributions made out of corporate profits accumulated since that time. (See Pet. Br. 11-12, 14, 15-16, 19, 24.)

In the *Canfield* case, *supra,* the Court, consistent with what we maintain should be the result in this case, looked to the aggregate earnings and profits in the post-1913 period and determined that the amount accumulated in that period exceeded the distributions in question. Accordingly, those distributions were ruled to be taxable as dividends. In the present case, it is similarly true that the earnings and profits in the post-1913 period exceeded such distributions (or passed to the Spreckles Company in sufficient amount to make its distributions taxable as dividends) and the same result should follow.

In the *Canfield* case, the more recent accumulations were properly held to be undiminished by the earlier, post-1913 losses since those losses reduced the pre-1913 surplus and, consequently, did not affect the amount of the later, post-1913 accumulations. What was accumulated after March 1, 1913, in that case was definitely affected by what surplus had been accumulated before that time, since this surplus was actually reduced by the earlier, post-1913 losses.

In the present situation, however, there is no occasion to look beyond March 1, 1913. Since there was a corporate deficit on that date, nothing in the prior corporate history could affect the amount of earnings and profits accumulated after that time. The patent error committed by the taxpayers is in thinking that, because a March 1, 1913 surplus remains available to absorb subsequent losses so that they do not diminish later accumulations of profits, it follows that a deficit

on March 1, 1913 (Br. 14-15) "likewise remains available to absorb subsequent earnings." But this is a complete *non-sequitur* and arises from the taxpayers' confused notion (Br. 15) "that to ignore the operating deficit is to tax as income that which in reality is a distribution of capital."

The *Canfield* case demonstrates that the contrary is true, and establishes this as an *a fortiori* situation for taxing the distributions. In *Canfield* the losses which took place immediately after 1913, as a physical fact, had reduced the assets existing on March 1, 1913, so that the later earnings represented augmentations of the corporation's worth and were accumulations available for dividend purposes. Here, too, the post-1913 earnings augmented the corporation's worth and, indeed, all those earnings augmented it over that existing on March 1, 1913—a matter which was not even true in *Canfield.* There is no reason why, consistent with the Congressional plan to tax such earnings when distributed (*Helvering* v. *Canfield, supra,* p. 168), they should not be available for distribution as taxable dividends. Furthermore, if the surplus existing on March 1, 1913, in the *Canfield* case was not to remain as undisturbed capital belonging to the stockholders, it is all the more clear that losses before that date need not be restored to guarantee the stockholders a theoretical capital equal to what would have been their investment if operating losses had not been incurred by the corporation before 1913. We need not repeat the analysis in our opening brief which, in all respects, demonstrates why the *Canfield* case is actually inconsistent with the result below. (Pet. Br. 15-21.)

In conclusion, passing reference may be made to the contention (Resp. Br. 4-6) that the Commissioner's position is one of "economic absurdity" which leads

to an "anomalous result." The anomaly is said to result from the supposed conclusion that there would be a different result if the stock were sold by the stockholders or if the corporation were liquidated and its assets sold. Even if this difference could be conceded to be correctly supposed (which we do not concede) nothing has been proved. In *Commissioner* v. *Phipps,* 336 U.S. 410, 419, the Court was referring to just such different ways of accomplishing a result and said: "We note in passing, in this connection, that such gain will correspond, if at all, only by coincidence with the amount of earnings and profits of the subsidiary." There are many instances where different tax results ensue when different transactions are carried out, even though the ultimate economic effect may be similar or the same. See also *United States* v. *Cumberland Pub. Serv. Co.,* 338 U.S. 451, 455, where the Court said:

> Congress having determined that different tax consequences shall flow from different methods by which the shareholders of a closely held corporation may dispose of corporate property, we accept its mandate. * * *

Other matters argued by the taxpayers have either been fully covered in our opening brief or else are so patently erroneous as to require no further answer.

The decision of the Tax Court should be reversed.

Respectfully submitted,

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